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C O N F I D E N T I A L SECTION 01 OF 02 ANKARA 002472

SIPDIS

STATE FOR E, EB AND EUR/SE
TREASURY FOR OASIA - MILLS AND LEICHTER
NSC FOR QUANRUD AND BRYZA

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TAGS: [EFIN](#) [PGOV](#) [TU](#)

SUBJECT: OUTGOING TREASURY U/S SAYS IT'S ALL ABOUT
CONFIDENCE

(U) Classified by EconCouns Scot Marciel. Reason: 1.5(b,d).

1. (C) Summary: Outgoing Treasury U/S Faik Oztrak believes Turkey has an opportunity to reduce its debt/GNP ratio and reach its five percent growth target this year if the government can restore market confidence, but he is not sure the government can and will stop giving the mixed signals that have so far undermined that confidence. Oztrak acknowledged that interest rates need to drop significantly, as current levels are unsustainable, but argued that a deep recession resulting in social turmoil is a greater risk than a debt default, at least this year. Oztrak said Foreign Minister Gul is the only minister who "gets it" when it comes to the economy. Ali Babacan understands economics to some extent, but has no clout; the others have no understanding at all. Oztrak also reported that IMF Managing Director Kohler delivered a tough message to Babacan April 14, essentially telling him that the IMF would not disburse loans to Turkey if it failed to fully implement sound policies. End Summary.

2. (C) During an April 15 farewell lunch, outgoing Treasury U/S Faik Oztrak (protect) offered his thoughts on the government and the outlook for the economy. (Oztrak said he would leave office by April 21 at the latest.) He expressed frustration that the current government, inclined toward populism, had squandered its credibility with the markets and thus missed a great opportunity to reduce real interest rates and Turkey's debt/GNP ratio. Similarly, it had lost credibility with the IMF, including through recent moves such as proposing spending any extra revenues gained through the tax amnesty program to compensate farmers for debt payments.

3. (C) Oztrak reported that the IMF's unhappiness with the GOT had manifested itself in Managing Director Kohler's tough message to State Minister Babacan in Washington on April 14. According to the read-out Oztrak received, Babacan began the meeting by saying that AK's effective implementation of the reform program should have inspired confidence. Kohler cut him off, saying he had a busy schedule and did not have time for political statements. Kohler then upbraided Babacan for the government's failings to date and warned that, should the government fail again, the Fund would not disburse the next tranche.

4. (C) Despite the government's failings to date, Oztrak believes the Turkish economy can end the year in better shape than it started. The government has completed all its prior actions for the Fourth Review, including passage of a strict budget, and the economy is much more resilient than it was two years ago. The key, he stressed, is confidence. If the government can restore market confidence by fully implementing the reform program, interest rates should fall significantly. In that case, consumer spending and private investment -- now held back by a lack of confidence -- also should rise, enabling Turkey to reach its five percent growth target despite (or perhaps because of) implementation of tight fiscal policy. (Oztrak said he had argued to the government that, if it fully implements the program, the resulting fall in interest rates should make it possible for it to spend, late this year, the 1.2 percent of GNP now affected by an emergency partial government spending freeze. This should be a huge incentive, he said, as it would stimulate the economy ahead of next Spring's local elections.)

5. (C) If, on the other hand, the government's actions fail to bring interest rates down significantly, Turkey will face serious problems. Oztrak argued that, while the risk of a debt default and financial crisis is always there, the greater threat -- at least in 2003 -- is that continued weak consumer/business confidence will keep domestic demand low and usher in a potentially deep recession that could result in social turmoil. (Note: Many analysts, noting that inventory accumulation accounted for a large share of 2002's 7.8 percent GNP growth, argue that domestic demand remains

weak. Several say that this fact, combined with the expected decline in tourism due to the Iraq war, suggests that growth is likely to be less -- perhaps substantially less -- than five percent this year.)

16. (C) Oztrak said he was not sure this government could and would take the steps needed to restore confidence. "They can do the right thing when there is enough market pressure, but you cannot take your eyes off them even for 24 hours." He said Foreign Minister Gul was the only minister who "gets it" when it comes to economics. Babacan "may understand," but nobody listens to him because, in the AK hierarchy, he is viewed as too young and junior. Also, he has lost all credibility, not only with the markets, but with the IMF and the USG. The remaining ministers do not understand economics at all. Some, he laughed, have criticized him and Central Bank Governor Serdengeçti for failing to lower interest rates (as if they had the power to do so). Oztrak admitted that the ministers do not trust him, since he is not "one of them." In that sense, Turkey may benefit from a new Treasury U/S if that person has the trust of AK leaders and a good understanding of what needs to be done. On the other hand, if the government replaces some or all of the Treasury Deputy U/S's with "its people," prospects for full implementation of the reform program will decline.

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